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No. 96-29

IN THE
Supreme Court of the United States
OCTOBER TERM, 1996

NORTHERN STATES POWER COMPANY,
a Minnesota corporation, and
NORTHERN STATES POWER COMPANY,
a Wisconsin corporation,
Petitioners,

v.

UNITED STATES OF AMERICA,
Respondent.

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Eighth Circuit

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BRIEF OF *AMICUS CURIAE* EDISON ELECTRIC INSTITUTE IN SUPPORT OF PETITIONER

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QUESTIONS PRESENTED

Edison Electric Institute adopts the questions presented in the Petition for Writ of *Certiorari* of Petitioner Northern States Power Company.

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BRIEF OF *AMICUS CURIAE* EDISON ELECTRIC INSTITUTE IN SUPPORT OF PETITIONER

Amicus curiae Edison Electric Institute (EEI) respectfully prays that the Court grant the Petition of Northern States Power Company for a writ of *certiorari* to the United States Court of Appeals for the Eighth Circuit in this matter. The Acting Solicitor General has consented to EEI filing this brief *amicus curiae* in support of Petitioner. The letter giving that consent is attached hereto.

INTEREST OF *AMICUS CURIAE*

Edison Electric Institute (EEI) is the association of the United States investor-owned electric utilities and their industry associates worldwide. EEI's U.S. members serve 99 percent of all customers served by the shareholder-owned segment of the U.S. industry. As of October 1995, they generated approximately 79 percent of all the electricity generated by electric utilities, and serviced 76 percent of all ultimate customers in the nation. EEI frequently represents its U.S. members before federal agencies, courts, and Congress in matters of common concern.

The members of EEI are among the nation's largest industrial and commercial enterprises, and their annual revenues and expenses, and the capital investment necessary to generate, transmit, and distribute electricity safely and reliably, are enormous by any measure. For these reasons, EEI's members are among the largest corporate income taxpayers in the United States, both in terms of their annual gross incomes and their annual taxes paid.

The magnitude, breadth, and complexity of an investor-owned electric utility's operations virtually ensure that each year's tax return will be scrutinized closely by Internal Revenue Service audit examiners. Moreover, even a small number of changes to a utility's taxable income will have a large tax impact. As a result, the Internal Revenue Service has organized specialized examination groups that focus specifically upon the electric utility industry, thereby ensuring intense scrutiny of utility tax returns.

Given the magnitude and scope of the proposed adjustments to which they are often subject, EEI's member utilities are particularly susceptible to the

harm resulting from the type of Internal Revenue Service actions in this case. As discussed below, the extent of the harm to which its members are exposed is exacerbated by the fact that several years will usually be consumed from the time the utility's tax returns are originally filed, and then examined by the Internal Revenue Service, to the time any disagreements over proposed adjustments are resolved through negotiation or, and most especially, litigation. Because the disputed overpayments and underpayments of utilities are large, the time required to pursue such matters typically involves a number of years, and the interest rate differential has been growing (and is now quite substantial), EEI's members are among those taxpayers most exposed to and harmed by the prejudice resulting from the government's position. Through actual cases, EEI will demonstrate to the Court the magnitude of the issue as it presently affects three of its members, and thus the unfair hardship that an unfettered discretion to net subjects all EEI members, all large, "accrual" taxpayers, and other corporate taxpayers as well.

SUMMARY OF ARGUMENT

EEI will provide three case studies to illustrate some typical amounts at stake, and highlight for the Court the impact of the Government's position. The actual situations of these three member companies reflect the extent to which "interest netting" (explained *infra*) can affect all of EEI's investor-owned electric utility members, as well as other corporations and all large taxpayers, and the extent to which the discretion granted to the Internal Revenue Service under the Eighth Circuit's ruling can be exercised to their financial detriment. In this case, in fact, had Petitioner not paid the $23.6 million in disputed as-

sessments prior to the 1990 increase in underpayment interest rates (Omnibus Budget Reconciliation Act of 1990 [OBRA], P.L. 101-508, 104 Stat. 1388, codified at 26 U.S.C. § 6621[c] [3% "hot interest" differential]), and had Petitioner been subjected longer than it actually was to a new lower overpayment interest rate (Uruguay Round Agreements Act [GATT], P.L. 103-465, 108 Stat. 4809 [4½% differential]), the additional $460,000 that the government is attempting to extract from Petitioner would be several times greater. Sums so large, especially coming as they do doing the current major restructuring of the electric utility industry, cannot fail but have an adverse impact on utilities, their ratepayers, and their shareholders, as well as on the economy as a whole.

The failure of the Internal Revenue Service to perform interest netting when a taxpayer has simultaneous tax overpayments (refunds due) and underpayments (deficiencies owed) constitutes a dramatic and needless departure from the inherent fairness and economic sense underlying the Internal Revenue Code's basic "use of money" concept. Rev. Proc. 60-17, 1960-2 C.B. 942; *see* Petition at 6. As the District Court noted below (Petition, App. 15-16, 20), the Republic will surely not fall if interest is computed on the sound principle that it is owed to the one party who, in the aggregate, has been a creditor of the other. The strong concern and vehement criticism expressed by large corporate taxpayers, tax professionals, and industry associations over the Eighth Circuit's decision are testimony to the economic importance of interest calculations and to the perception that a refusal to net is fundamentally unfair, supremely harsh, and flatly contrary to the expressed will of Congress. *See* references at Petition 29-30.

Moreover, as noted in the Petition (26-29) the decision below is in direct conflict with a decision of the Seventh Circuit.

It would be unreasonable to assert that the years of underpayments in this case (and any other similar case) are distinct from or otherwise unrelated to the years of overpayments—in fact, they are so directly and necessarily related (as more fully described *infra*) that netting is required, at the least, for equitable and just administration of the tax laws. Moreover, the position of the Internal Revenue Service elevates form over substance, and actually rewards taxpayers for failing to pay disputed amounts prior to the resolution of the dispute. For all of the foregoing reasons, the decision of the Eighth Circuit should be reviewed and its erroneous views corrected, in order to prevent the government from continuing to exercise the discretion the decision below confers.

REASONS FOR GRANTING THE PETITION FOR A WRIT

I. BACKGROUND AND INTRODUCTION.

Adjustments to the returns of investor-owned utilities proposed by the Internal Revenue Service examining agents almost never involve income that the utility has clarly omitted, or items that are inherently not deductible or recoverable for tax purposes. Rather, the examination of a utility's tax returns usually involves disputes regarding the proper application of the "accrual" method of tax accounting, which all investor-owned electric utilities (as well as most industrial and other large commercial taxpayers) are required to follow in reporting their income and items of deduction. Under the accrual method, "timing" questions arise—*i.e.*, when income and deduc-

tions must (or may) be recognized for reporting purposes. The need to apply "interest netting" arises from timing-related adjustments of utility returns—in fact, whenever there are simultaneous tax underpayments and overpayments—because of the differing interest rates applicable to such underpayments and overpayments and, in the words of the district court, "the agonizing slow administrative process of the Internal Revenue Service" (Petition, App. 16).

A. Accrual Accounting Gives Rise to Timing Adjustments.

Most corporate income taxpayers of any significant size in the United States report their tax liabilities under an accrual method of accounting as permitted by Section 446(c)(2) of the Internal Revenue Code. Pursuant to Section 446(a) of the Internal Revenue Code and Treasury Regulation Section 1.446-1(c)(2), an accrual method is necessary whenever the taxpayer keeps its financial books pursuant to an accrual method or when it maintains an inventory. Without exception, all investor-owned utilities report their tax liabilities under an accrual method of tax accounting.

Under the accrual method, income is reportable for the taxable years in which "all the events" have occurred that fix the taxpayer's right to receive the income and the amount can be determined with reasonable accuracy. Treas. Reg. § 1.446-1(c)(1)(ii). Correspondingly, under an accrual method, a liability is incurred and generally deductible in the year in which "all the events" have occurred that establish the fact of the liability, the amount thereof can be determined with reasonable accuracy, and economic performance by the taxpayer with respect to the liability is deemed to have occurred. *Id.*; Treas. Reg. § 1.461-1(a)(2).

These broad principles can be stated only generally, however. In the facts and circumstances of any given case, the specific application of those tax accounting principles may be unclear and disputed, creating timing issues which carry large tax consequences for any particular group of years riding on the outcome. For example, in a series of cases, utility companies and the Internal Revenue Service argued over whether utilities must report certain revenues in the year in which the utilities had provided electricity to their customers but had not yet read their meters and billed them, or whether such revenues were reportable in the later year when the utilities had billed their customers for the electrical service in question. *Public Service Co. of New Hampshire v. Comm'r*, 78 T.C. 445 (1982); *Orange & Rockland Utilities v. Comm'r*, 86 T.C. 199 (1986).

Timing issues similarly arise on the deduction side of a taxpayer's liability. An accrual method taxpayer may, for example, find itself at odds with the tax collector over when a contract or tort liability has become fixed and when the amount of the liability has become reasonably determinable. *See* Section 461(a) of the Internal Revenue Code; Treas. Reg. § 1.461-1(a)(2); *see, e.g., Mooney Aircraft, Inc. v. U.S.*, 420 F.2d 400 (5th Cir. 1969). Other opportunities for disputes involve when a loss is sufficiently defined to permit a deduction (*see* Treas. Reg. § 1.165-1(d) and *De Nardo v. Comm'r*, 48 T.C.M. 1049 [CCH] [1984]); when newly acquired property is deemed to have been first placed "in a condition or state of readiness and availability for its assigned function" sufficient to permit the taxpayer to begin claiming depreciation (*see* Treas. Reg. §1.167[a]-

11[e]); and, whether certain items are currently deductible as business expenses or must instead be capitalized and their cost recovered for tax purposes in later years through depreciation or through sale or disposition of some asset (*see INDOPCO, Inc. v. Comm'r*, 112 S.Ct. 1039 [1993]).

B. Timing Adjustments and Interest Differentials Create Significant Netting Disputes.

By asserting that income should have been recognized and reported by a utility for an earlier period than the year for which it was reported by a utility, the Internal Revenue Service will, by definition, be asserting an underpayment for that earlier year. Concomitantly, however, that will, in almost every instance, create a corresponding overpayment for the (later) year during which the utility had originally reported the income. Conversely, if the Internal Revenue Service denies a deduction for the year claimed by the utility, and instead allows the deduction for a later year or years, the Service thereby will have automatically created both a deficiency for that earlier year, and corresponding overpayments for the later year (or years).

As can be seen, these timing adjustments create both underpayments and corresponding overpayments. And, as noted in the Petition (9-10), differing interest rates apply to overpayments and underpayments. *E.g.*, Tax Reform Act of 1986 § 1511(a), P.L. 99-514, 100 Stat. 2085 (1% differential). Therefore, given the large size of the underpayments, and the resulting overpayments, typically asserted in a utility timing adjustment, electric utility tax-related interest netting disputes can be of significant magnitude.

C. The Lengthly Process of Resolving Tax Disputes Exacerbates the Impact of the Interest Differential.

Delays are inherent in the administration of the tax system. At the outset, a utility's returns are complex and time-consuming for the Internal Revenue Service to examine. Moreover, two or more returns are usually grouped together for examination by the Internal Revenue Service. Thus, extensions of time for field examinations are routinely sought by the Internal Revenue Service and granted by utilities.

The field examination of a utility's returns is then usually followed by an agency appeal process within the Internal Revenue Service to determine the extent to which the field agents' proposed adjustments can be resolved without litigation. If this administrative process concludes with issues still outstanding, the utility may wish to challenge the government in refund or Tax Court litigation. As in Petitioner's case, a refund suit requires additional periods of time for the processing of the assessments by the Internal Revenue Service, the taxpayer's payment of the tax and assessed interest and filing of administrative claims for refund, and the opportunity for the Internal Revenue Service to either review or ignore the claims before suit becomes permitted (Internal Revenue Code § 6532[a]).

The litigation process itself often adds another two to four years to the dispute before the correct tax liabilities of the utility can be finally determined and the existence, amount, and duration of any individual tax year overpayment and underpayment can be conclusively determined. Thus, it is only years after returns are filed that the utility will even know whether it has overpayments and underpayments that

could offset each other, for interest computation purposes, through netting. *See, e.g., Houston Industries, Inc. v. U.S.*, 78 F.3d 564 (Fed. Cir. 1996), in which the trial court's decision in 1994 relating to two issues involving taxable years 1983 and 1984 entitle the utility to refunds that, with statutory interest, would presently exceed $100 million.

II. FAILURE TO APPLY INTEREST NETTING UNFAIRLY INCREASES TAX LIABILITIES AND CAN HAVE AN ENORMOUS FINANCIAL IMPACT.

EEI supports the Petitioner in seeking review of the unfounded and ill-advised result reached below. EEI submits this *amicus* brief to emphasize that (1) the government's refusal to compute interest under a netting method irrationally distorts the impact of purely timing adjustments, and (2) the magnitude of the economic distortions here at issue are so enormous that the Congress could never have intended to give the Internal Revenue Service the unbridled discretion that the Eighth Court's decision presumes. *Northern States Power Co. v. U.S.*, 73 F.3d 764 (8th Cir. 1996). The degree of unchecked discretion that the Eighth Circuit believes the Congress has conferred upon the Internal Revenue Service threatens uniformity and consistency in application of the tax laws across the country. The discretionary exercise of such raw, *ad hoc* power to deny netting is blatantly unfair to taxpayers, and provides a perverse incentive for asserting questionable timing adjustments subject to the interest differential.

Investor-owned electric utilities, being large, accrual method taxpayers, are particularly subject to the imposition of large tax deficiencies, a significant portion of which results from "timing" disputes that

offer an opportunity to create a further dispute over interest netting. Often, and as in Petitioner's case, asserted tax deficiencies are grossly erroneous and millions of dollars will be refunded to the utility—however, only after several years of costly litigation has concluded in a settlement or court ruling in the utility's favor. *See, e.g., Houston Industries, supra.* Given the magnitude of the proposed adjustments to which utilities are often subject, and the magnitude of refunds that are finally owed to them, utilities are especially susceptible to the harm resulting from the refusal of the Internal Revenue Service to compute interest on a netting basis. However, under the decision of the Eighth Circuit, and the position maintained by the government, there is no planning that a utility could undertake which would ensure protection against the government's asserted interest calculation discretion.

At the outset, EEI states that it supports Petitioner's legal arguments in support of its contention that interest netting is required by the terms of Section 6601(f) of the Internal Revenue Code and Section 1511(b) of the Tax Reform Act of 1986, as explained in the relevant legislative history attendant to those statutes, as well as the pertinent committee reports addressing the 1990 OBRA and 1994 GATT interest rate changes. Moreover, the decision below conflicts with a directly applicable case from the Seventh Circuit. *Pettibone Corp. v. U.S.*, 34 F.3d 536, 539 (7th Cir. 1994). In a nutshell, both the Eighth Circuit and the government have confused the debt collection "credit" available under Section 6402(a) of the Internal Revenue Code with the interest computation "credit" required under Code Section 6601(f)

and Section 1511(b) of the Tax Reform Act of 1986. The Section 6402(a) debt collection credit is discretionary with the Internal Revenue Service. The interest computation credit, however, is mandatory and self-executing, because it is necessary to implement the Code's "use of money" rationale (*see* Petition at 6-7).

A. The Government's Refusal to Net Unfairly and Irrationally Distorts the Impact of Purely Timing Adjustments.

For utility companies, and other large corporate income taxpayers, timing adjustments pose enormous, adverse financial consequences if interest is not computed on a netting basis. Utilities and other large taxpayers continually face timing adjustment disputes with the Internal Revenue Service. This is true because their income, expense, and tax credit items are large, the underlying facts are often complex, the accrual method rules are frequently debatable, and because the examining agents gravitate to utility industry timing issues because of the potential size of any successful adjustments. For instance, a determination by the Internal Revenue Service that $10 million of maintenance work performed on the turbine generator of a power plant should not be currently deducted as a repair expense in the year the utility incurred the obligation, but instead should be capitalized and depreciated, will generate a deficiency of approximately $3.5 million in tax, plus interest, for the year in question.

However, there will be corresponding overpayments in later years resulting from the $10 million in "previously" unclaimed additional depreciation deductions. Logically, and in fairness, these resulting over-

payments—which exist only by virtue of the determination that there had been underpayments—should be available to offset the $3.5 million underpayment for interest calculation purposes, even if the disallowance of the deduction proves correct. Under the Eighth Circuit's view, however, the utility will never obtain that result as a matter of law or right. On the one hand, if the utility disputes the adjustment, pays the $3.5 million deficiency, and then files a refund suit, it can never obtain interest netting under law, because the deficiency has been artificially determined to no longer exist. On the other hand, if it does not pay, and instead files a petition with the Tax Court challenging the proposed deficiency before the assessment is made, the Eighth Circuit would still grant the government the discretionary authority to decline netting.

If interest netting were available as the Congress intended, however, such timing adjustments would have only the result of increasing a tax liability for one year but decreasing it for one or more later years, consistent with congressional intent. In the above example, the taxpayer would then incur an economic timing cost equal only to the loss of use of the additional taxes determined to be owed for the earlier year, up until the later overpayment(s) arose and became available to offset the underpayment.

Without interest netting, though, the economic impact of a timing adjustment is grossly distorted by the government's refusal to shut off the running of the higher rate of interest even when corresponding overpayments result from the adjustment. When computational interest netting is denied, when the underpayments and overpayments are large, when

several years are consumed in the dispute resolution process before the existence and extent of the underpayment and overpayments can be conclusively established, and when the rate differential is as high as 4½% compounded daily, the financial consequences attending a pure timing adjustment become absurdly high and entirely disproportionate in terms of economic and tax policy. Surely Congress never intended such an irrational, unfair, and unjust result.

B. Refusal to Compute Interest on a Netting Basis Creates Interest Charges for Utilities That Dwarf Those Imposed Upon Petitioner in This Case.

To illustrate the application of the Eighth Circuit decision on EEI member companies and other large corporations, EEI describes below the situations of three different utilities. These actual cases demonstrate the potential real-world economic consequences of applying the deficiency rate of interest (currently 11%) to the underpayment years that are yet to be resolved, while simultaneously applying the refund rate of interest (currently 6.5%) to overpayment years that are also in the process of being resolved. Because the following three controversies are ongoing and unresolved, EEI is not authorized to specifically identify the utilities, and the descriptions represent best-estimate projections of the amount of underpayment liability and overpayments to be refunded and potential dates of resolution.

1) The first EEI member expects that claims for refund for the years 1986 through 1990 will not be resolved except through litigation. The amount of the refund in dispute is $60 million. In addition, the company expects to owe a deficiency of $19 million

for the year 1991. The projected date of resolution is November 1, 2000, which is four years from the scheduled completion date of the current Internal Revenue Service examination.

If the litigation is resolved on November 1, 2000, and the Internal Revenue Service does not net the $60 million in overpayments for the years 1986 through 1990 against the $19 million underpayment for 1991, the taxpayer will be charged an additional $9 million of interest. Without netting, the higher interest rate would apply to the $19 million for approximately eight years—from March 15, 1992, the due date of the 1991 return, until November 1, 2000. During this same eight-year period, the $60 million overpayment would earn only the lower (6½%) rate of interest. With netting, the $19 million underpayment would offset part of the overpayment, and interest would be paid, at the lower rate, on the $41 million net overpayment to be refunded.

In this situation, the government will have had the use of $41 million of the utility's money for eight years. To view the $19 million underpayment for 1991 and the $60 million of overpayments for the years 1986 through 1990 as separate unrelated debts is inconsistent with the fact that tax years are in fact interrelated. The interdependence between a corporation's individual tax years makes it inappropriate not to treat them as related for interest computation purposes. *See Pettibone Corp. v. U.S., supra,* 34 F.2d at 539.

2) The second EEI member is facing a decision of whether to compromise issues at the administrative level or bring suit. The company, which has resolved the issues for the years 1986 through 1989, is due

refunds for these four years of $7 million. Tax deficiencies of $22 million are projected for the years 1990 and 1991. Up to the due dates of the 1990 and 1991 returns, the overpayments for the tax years 1986 through 1989 have earned interest of approximately $2 million, which makes a total amount of $9 million of tax and interest available to offset the $22 million owed for the later years.

If the company and the Internal Revenue Service could reach a resolution today, the difference between netting and non-netting is $800,000. If the company and the Internal Revenue Service cannot reach an administrative resolution and the litigation process takes four years, however, the difference between netting and non-netting is $4 million. In making a decision on whether to compromise or litigate, the company must not only evaluate the merits of its position under the tax law, but must also consider the unknown factor of whether the Internal Revenue Service will exercise its purported "discretion" to apply interest netting. Clearly, however, under the Eighth Circuit decision, the government does not have much incentive to exercise any such discretion and apply netting.

3) The third EEI member has already been in litigation for a protracted period. The case has proceeded to the point where it is now known that the aggregate overpayment over three years, exclusive of interest, is approximately $65 million, which far exceeds the remaining potential tax that is still to be resolved for a single later year—a possible underpayment of $25 million. If, for example, in July 1997 it is finally determined that the company owes the $25 million, the difference in the interest computation be-

tween netting and non-netting will be more than $11 million.

This company has no satisfactory path to choose. Under the ruling below, the Internal Revenue Service will have the only significant choice: will it charge the underpayment rate of interest on the $25 million deficiency from the return's due date to the date of payment by the utility (a span of more than 10 years), but pay the overpayment rate of interest on the far larger overpayments, or will it net the two amounts and pay only the overpayment rate for the remaining refund due? Under the Eighth Circuit's decision, the decision whether to impose an additional $11 million charge upon the utility by simply refusing to net the overpayments against the underpayment is entirely at the discretion of the Internal Revenue Service. Again, the government does not have much incentive to exercise its discretion and apply netting.

CONCLUSION

WHEREFORE, Edison Electric Institute prays that the Court grant Northern States Power Company's Petition for a Writ of *Certiorari* to the United States Court of Appeals for the Eighth Circuit in this matter.

Respectfully submitted,

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